DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 08-0143
Income Tax
For Tax Years 2002-03

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ISSUE

I. Adjusted Gross Income Tax–Consolidated Filing.

Authority: IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-110; *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

Taxpayer protests the addition of a related company to its consolidated adjusted gross income tax return.

STATEMENT OF FACTS

Taxpayer is a corporation which sells and markets products produced in Indiana by an affiliated corporation. For the tax years 2002 and 2003, Taxpayer ("Company A") filed a consolidated adjusted gross income tax return with its Indiana-domiciled affiliated corporation ("Company B"). As the result of an audit, the Indiana Department of Revenue ("Department") determined that certain royalty payments to a third related corporation ("Company C") should be disallowed and added back to Taxpayer's Indiana adjusted gross income. As explained in the audit report, Taxpayer stated that Company C had nexus with Indiana and should be taxed accordingly. The Department agreed to add Company C to the consolidated return, thereby eliminating the distortion created by the royalty payments. The Department issued proposed assessments for adjusted gross income tax, penalty, and interest. Taxpayer protests the determination that it should file the consolidated return with Company C and the proposed assessments for adjusted gross income tax. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Consolidated Filing.

DISCUSSION

Taxpayer protests the Department's determination that Taxpayer should be filing a consolidated return with an Indiana based affiliate and a third related company. Taxpayer states that either Companies A and B should file a consolidated return and Company C should file a separate return, or all three companies should file a consolidated return which includes every corporation in its federal combined group. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The Department audited Taxpayer for the tax years 2002 and 2003, and determined that Taxpayer should file a consolidated Indiana adjusted gross income tax return with both Company B and with Company C. In 1998, Company A formed Company B and Company C. Company C is a Delaware holding company whose only assets consist of intellectual property contributed by Company A in an IRC Section 351 tax-free exchange upon the formation of Company C in 1998. In the tax years 2002 and 2003, Company A and Company B paid royalties to Company C for the use of trademarks, patents, and franchise rights held by Company C. As explained in the audit report, Company C loans the royalty proceeds back to Company A, but Company A made no principal payments during the audit period. There are no separate general ledgers for Company A, Company B, and Company C. Company C engaged in no activity to enhance or ensure the continued value of the intellectual property. Company C had no employees. Company A's employees and officers provided the management and accounting services for Company C. The Department determined that the flow of royalty payments from Company A to Company C and loans from Company C back to Company A distorted Company A's Indiana sourced income.

The first option considered by the Department was to disallow the royalties and related expenses on the consolidated return filed by Company A and Company B. The Department believed that this would cure the distortion in question. Taxpayer asserted that Company C had nexus with Indiana under the standard established under *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993). While a South Carolina court case is not controlling in Indiana, the Department accepted the proposition that Company C had nexus with Indiana. The Department then determined that a consolidated return including all three companies would cure the distortion without the need to disallow the royalty and related expenses. The Department referred to IC § 6-3-2-2, which states in relevant part:

> (*l*) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
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> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The Department then referred to 45 IAC 3.1-1-110, which states:

An affiliated group as defined in IC 6-3-4-14(b) may file consolidated returns for Adjusted Gross Income Tax and Supplemental Net Income Tax purposes if the members of the affiliated group consent to follow the provision of IC 6-3-4-14 and the regulations established thereunder, including Federal regulations promulgated pursuant to Internal Revenue Code section 1502 which are incorporated by reference in IC 6-3-4-14. The inclusion of a member of an affiliated group in the consolidated return is deemed to be its consent to the consolidated filing. Once an election is made to file consolidated, a taxpayer must obtain written permission from the Department to change from this method of reporting. Taxpayers filing consolidated returns should notify the Department of their election to so file by attaching to their first consolidated return a statement indicating which corporations are joining in the return. In addition, a worksheet must accompany all consolidated returns showing the consolidated income of the affiliates.

Also of relevance is IC § 6-3-4-14, which states:

(a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.*

(c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.

(d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group.

(*Emphasis added*.)

The Department determined that the best method to fairly reflect income from sources in Indiana was for Company A, Company B, and Company C to file a consolidated adjusted gross income tax return.

Company A protests that it should be allowed to continue filing a consolidated return with Company B and that Company C should file a separate return using the method explained by *Geoffrey*. Taxpayer believes that this would fairly reflect Indiana sourced income. As previously stated, a South Carolina court case is not controlling in Indiana. Also, Company A has not provided a detailed analysis with supporting documentation establishing that its proposed method is superior to the Department's method to fairly reflect Indiana sourced income. Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

Similarly, Company A proposes that in the event that the Department determines that Company C should not file a separate return, then the Department should allow the companies to file a consolidated return which would include all other members of its federal 1120 consolidated group. As provided in IC § 6-3-4-14(b), the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana. Company A has not provided sufficient documentation to establish that any other members have adjusted gross income derived from sources within Indiana. Therefore, the only members which are eligible to be included in a consolidated return are Company A, Company B, and Company C. Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

Next, Company A states that during the tax years 2002 and 2003 there were no laws in the Indiana tax code which prohibited these types of payments between related entities. Taxpayer is correct that there were no Indiana Code provisions which explicitly prohibited these types of payments. However, IC § 6-3-2-2(*l*) and (m) were in

effect at those times and the Department determined that the adjustments were necessary to fairly reflect Indiana sourced income. Therefore, the Department had the authority under the Indiana Code to make the adjustments. Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

In conclusion, there was distortion of income derived from Indiana sources by Company A and Company B. The inclusion of Company C on a consolidated return cures that distortion. There is insufficient documentation and analysis to support the proposed alternative methods of separate filing for Company C or inclusion of the entire federal 1120 consolidated group on an Indiana consolidated return. Finally, the Department relied on existing Indiana Code sections to make its adjustments. Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

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